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"I am convinced we have passed the worst and with continued effort we shall rapidly recover."

U.S. President, Herbert Hoover
May 1, 1930

HIGHLIGHTS

Surprisingly strong growth in the U.S. last year and the official pronouncement of a new expansion has prompted forecasts of faster growth and a "productivity-led" recovery. While growth was stronger than expected, these forecasts couldn't be more wrong.

Facts are facts. In vain, we searched the history books and theory for a type of recovery that is allegedly occurring now in the United States. Such a development has never occurred before.

Wall Street, though, is promoting a new story: "a productivity-led recovery." But with net private domestic investment down to barely 2% of U.S. GDP, these forecasts couldn't be more bizarre.

Such a low investment ratio has only occurred once before in history: in 1929-39. The difference is that it's even worse today because it coincides with a large current-account deficit.

Can the U.S. break out of the vicious circle of low investment, secularly low productivity and low profits? It's a daunting task for U.S. policymakers. Clinton's policy package may not be enough.

If nothing is growing — neither money, credit, jobs nor income — it becomes a bit hazardous to explain how the economy can possibly grow. We list the numerous differences between this latest recovery and that of the more normal postwar variety.

What has driven the economy so far is the soaring budget deficit and the profligate, spendthrift consumer. On this base, the recovery can't continue very long. A renewed weakening of the U.S. economy will be the biggest surprise and shock for the consensus view and the markets.

Investors in dollar bonds should be warned. What we see is a huge, combustible pyre of overinflated stock and bond prices piled ever higher by a central bank that can only tighten at the peril of the financial system and the economy.

Worldwide, we see nothing but worsening conditions in Europe, Japan and soon again in North America. For the time being, there isn't any locomotive in sight.

We remain bearish on the U.S. dollar for two main reasons: overinflated recovery expectations and the long-term structural deformations in the U.S. economy that impede a cyclical upturn.

Hard currency bonds — the top-quality government bonds of Germany and Switzerland as well as Austria, Belgium and the Netherlands — remain the safe haven for prudent long-term investors.

A WELL WORN ROAD TO CRISIS

"Let's just face reality." With this bold demand, President Clinton sought to banish Reaganomics to the history books. Introducing his new budget, Mr. Clinton pointed to many things that have long been the object of our criticism in these letters. He mentioned such things as low investment, low savings, low productivity and even such technical concepts as the "crowding out" effect of government borrowing. It sounded good. It goes without saying that we were highly pleased with the public recognition of such factors critical to the long-term health of the U.S economy.

Although hopes are high, what remains a big question is whether President Clinton's medicine for all of these ailments — a highly complex mix of tax hikes, tax incentives, spending cuts and spending programs — is just as good as his vision. Despite well-intentioned goals, we can discern very little in the budget that will veer the U.S. off its path of economic deterioration. Immense, intractable hurdles stand in the way. Just what is the reality?

THE INERTIA OF THE PAST

The past record of the U.S. economy is well known. With the lowest savings and investment ratios of all the industrial countries, U.S. productivity growth fell to a new low of only 0.8% per year in the 1980s. Income growth virtually stalled already as far back as 20 years ago. Seen from a long-term secular perspective — ignoring the short-term cyclical fits and spats — the U.S. economy has succumbed to anaemia. To perk it up, the economy needed the tonic of real estate and stock price inflation and an associated borrowing binge to raise living standards. As such, a persistent and extreme divergence emerged between the performance of the financial and economic spheres which was truly unprecedented in history. The average American instinctively knows, even if only imprecisely understood, that Reaganomics badly went wrong and that something needed to be done. But what?

There is public enthusiasm for the new president, his policies . . . to say the least, there are extremely high expectations of him. But while the need for sacrifice seems to be widely recognized, hope remains that an economic miracle can be produced without serious pain. Already, economists and pundits are pronouncing a new era of productivity-led growth and eternal financial nirvana. The mood has moved from complacency to high hopes. For that reason, we fear that the shocks of reality will even be greater.

In fairness, the final judgment on Clintonomics has to await the final budget details and the tests of time. But, at the outset, we have our serious doubts for a number of reasons. The devil is not merely in the detail; it is also in other forces and influences of crucial importance. In particular, four questions of vulnerability come to mind: firstly, the near-term strength or weakness of the U.S. economy; secondly, the long-lasting legacy of past structural deformations; thirdly, repercussions from the world recession; and lastly, the impatience of the public and the markets to wait out the results.

THE PROSPECT OF DASHED RECOVERY HOPES

The first danger for Clintonomics is the disappointment of all of the excessively optimistic recovery forecasts for the U.S. economy in 1993. According to the official verdict of the seven University professors of the Business Cycle Committee of the NBER, the Bush recession ended in April 1991, almost two years ago. Now, more or less, the consensus has come to accept that an expansion is under way and expects a strengthening recovery. Essentially, what this implies is that any new weakening of the U.S. economy will — rightly or wrongly — be blamed on Mr. Clinton's policy package . . . in particular on his tax hikes.

Considering the U.S. economy's protracted sluggishness during the past few years, its recovery in 1992 appears impressive. But compared with all other postwar recoveries, it's actually been unusually feeble. Real U.S. GDP (Gross Domestic Product), according to the statistics, increased 2.1% in 1992, in contrast to a decrease of 1.2% the year before. From the fourth quarter of 1991 to the fourth quarter of 1992, real GDP grew by 2.9%. The typical growth rate in the first year of a cyclical postwar recovery, however, has been 6.1%. The 1992 surge was less than half the normal rate.

Our critical assessment of the present U.S. economic upturn has its root in structural issues, not in the evidence of its sluggish growth. The recovery is extremely ill-balanced and poorly propelled thus barring dynamic, healthy growth. Firstly, we are concerned with the composition of the demand impulses that have driven this U.S. recovery so far. There are two of them. Both are not sustainable. One was a big fiscal stimulus as is reflected in the soaring budget deficit, and the other was a new borrowing and spending spree by the consumer who slashed the already miserable savings ratio from 5.1% — which hardly recovered at all during the recession — to 4.6%.

What we are also concerned about is the recovery's structure. Personal consumption accounted for 73% of GDP growth in the second half of 1992. Again, consumption was boosted at the expense of savings which were already grossly insufficient. Surely, that's the last thing that ought to happen if the U.S. economy is supposed to rehabilitate itself into an investment-led, productivity-driven dynamo. Also, such a spending binge on the part of the consumer oddly contrasts with the poor job and income growth. Any increase in real consumer income has had to come from the soaring budget deficit, largely facilitated through income transfers. "Real personal income less transfer payments," a component of the Coincident Indicators, has been virtually flat for three years.

THE MISSING ENGINE: JOB AND INCOME GROWTH

Much has been written about the flagging growth of jobs and incomes in this U.S. recovery. Both have lagged badly. For example, real personal income has risen 5% on average during the first year of all postwar recoveries. This time, income growth has barely mustered a pace of 1%. Even this meagre rate owes its existence to the mentioned surge in transfer payments.

Had payroll employment growth matched the rate of the previous three postwar recoveries, over 5.0 million jobs would have been created since the official start of the recovery 23 months ago. Instead, employment growth has only been one-tenth of that. For the 1992 year, job growth was a mere 700,000. But beware. This modest job growth figure for 1992 is wholly a result of a subsequent sharp downward revision of the employment figures for 1991.

The immediate and main concern is the sustainability of the current upturn. Clearly, the markets desperately want to believe in the recovery forecasts and therefore grab at any data that might confirm this wish no matter how irrelevant and unreliable they may be as economic indicators. The irony is that, with little exception, all data of strategic importance — money and credit, jobs and incomes — speaks directly against a sustained economic recovery. In fact, to the contrary, these statistics signal more weakness.

INDICATORS OF AN UNUSUAL RECOVERY

Though the U.S. upturn is supposed to have started almost two years ago, money, credit, jobs and incomes have yet to show any real life despite what must be considered one of the most massive monetary and

fiscal stimuli on record. Ominously, again, the money data are trending from bad to worse. M2 and M3 growth, performing sluggishly all along, has recently begun to nosedive.

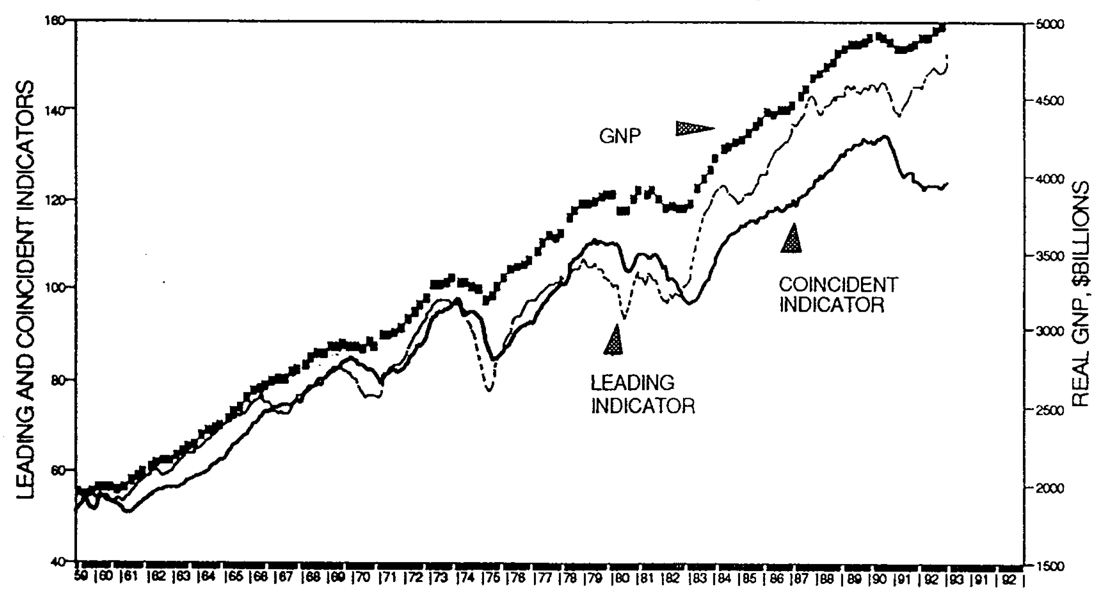
Of all the many gross contradictions in the statistics, there is one that we find particularly intriguing: the unusual and extreme divergence between GNP growth and the indexes of early and coincident indicators. The graph below highlights our point.

The government's monthly composite index of coincident indicators hasn't received very much attention from the public. It sharply contradicts the GNP growth data. The coincident index is constructed to reflect the current economic development and is comprised of four data series of outstanding importance: 1) industrial production, 2) manufacturing and trade sales, 3) real personal income less transfer payments, and 4) employees on non-agricultural payrolls.

All through the postwar period this index has displayed a perfect correlation with current GNP growth. Now, for the first time ever, the trend of the two has diverged drastically. If we were to judge by the index of coincident indicators, there hasn't been any recovery at all.

U.S. INDICATORS VERSUS GNP, 1959-92

Indicators Monthly, GNP Quarterly



MONEY AND CREDIT: A RED FLAG

What really argues with the U.S. recovery forecasts as never before is the money and credit data. To understand why the money supply figures are so weak, one has to check the source — the balance sheets of commercial banks and thrifts. We did so again and must report that the evidence is irrefutable: bank lending is as dead as ever. The only banks that are still lending on American soil are foreign-related institutions. These institutions increased their loans by $30 billion last year while U.S. domestic banks reduced theirs by $20 billion.

Banking activity has been confined to piling up government bond holdings and not much more. Last year their bond investments rose by $100 billion to $661 billion. Since 1989, these holdings have risen from $396 billion, or by an astounding 67%. This increase, taken over three years, has been roughly equivalent to financing the budget deficit of one whole year. It's important to understand the impact of this activity on money creation and the stock and bond markets especially as it involves the actions of the Federal Reserve. Last month's letter delved heavily into this topic. Since it's such an important actor in the current financial mania, it's well worth rereading.

A sudden new and sharp slowdown in money growth started in November 1992. It is broadly based and for the first time also includes M1. Since there is no ready explanation for this downturn, we hesitate to draw any conclusions. Yet, it requires careful attention.

If nothing is moving up — neither money, credit, jobs nor income — it becomes a bit hazardous to explain how the economy can possibly grow. However, Wall Street, to its credo, is always quick in finding an upbeat answer. Presto, the strange, jobless expansion has been championed and heralded as "a productivity-led recovery."

WHAT IS A PRODUCTIVITY-LED RECOVERY?

In vain we searched the history books and theory for the type of recovery that is allegedly occurring now. Such a development has never occurred before. We guess that's because a "productivity-led recovery," as Wall Street uses the term, is an economic anachronism. It's a misuse of the word and a misunderstanding of what productivity really is. This latest slogan of Wall Street really suggests the impossible: that an economy can expand on a sustained basis even though it is deprived of its chief source of consumer purchasing power — rising wage and salary income. If so, it essentially implies a permanently rising budget deficit which would be required to generate the necessary addition to consumer purchasing power as happened, in fact, last year.

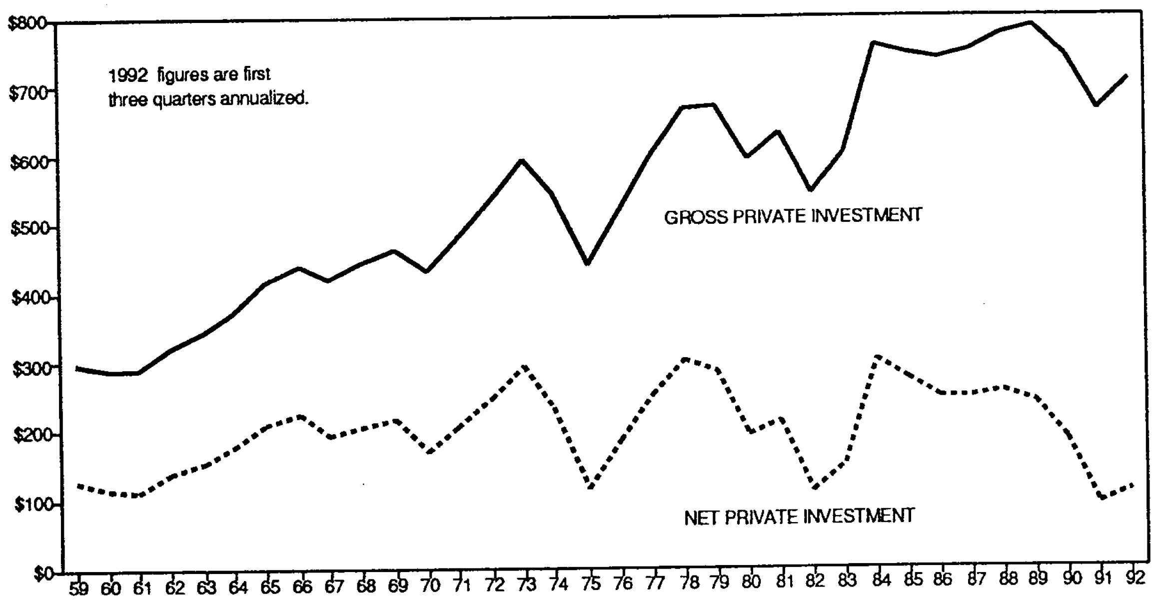
Much has been trumpeted of last year's strong productivity performance in the U.S., citing it as evidence of a new secular trend of productivity-driven growth. Labour productivity growth increased 2.6% in 1992, a sharp rise from previous years. The pundits have quickly seized on this data and are pronouncing that it is not just a "*cyclical pop*" and that the "*productivity-led growth of the 1990s will be dramatically different from the employment-led growth of the 1980s.*"

Actually, the productivity performance in 1992 is pretty normal for the first year of a cyclical upturn. In fact, measured over the official seven quarters of recovery so far, productivity growth clocked in at a total of 4.6%, slightly less than the postwar average of 4.8%. What is abnormal in this scenario is that the output growth has been so low — no more than 2.1% in 1992, compared with the more normal first-year average of 6.1%. GNP growth, in other words, has been strictly limited to the confines of productivity growth leaving zero contribution from employment growth. This is a crucial element that demands explanation.

As we have always stressed, sustained cyclical recoveries are always a function of investment spending and inventory changes with residential construction playing a key role. During the first two years of the Reagan recovery of 1983-84, U.S. GDP grew by a total of 10.1% of which investment spending contributed 56%. During the 1976-77 recovery, when U.S. GDP increased by 10.6%, investment was also the source of half of the growth — 51%. All other postwar business cycles witnessed similar proportions.

U.S. GROSS AND NET PRIVATE DOMESTIC INVESTMENT

Billions, 1987 Dollars



Source: Economic Report of the President, January 1993, p.365

Aborted recoveries always reflect aborted investment. These have been rare events, however. In living memory there have been three such occasions: 1933-39, 1980-82 and the present one. This latest recovery, as mentioned, was supposed to have started in April 1991. True, investment spending — especially residential construction — has recovered in 1992 but it has done so at less than half the normal pace. Altogether, construction is up 17% over the last two years and compares dismally against growth rates of 40% and more in the first two years of past U.S. business cycles.

Having pointed out the past role of investment, we come to a basic difference in thinking between American and non-American economists. For the former, consumption, being by far the biggest GDP component, is the dominant force that drives the economy and the business cycle.

Not so abroad. All foreign economic theories — those of Keynes included — emphasize the dynamic role of investment spending in the business cycle and identify it as being the most volatile GDP component. In their model it is soaring investment expenditure, which, via the so-called multiplier, leads to the big increases in production, jobs, wages and salaries that ultimately fuel rising consumer spending. If investment spending is turned off, the consumer loses purchasing power.

The above chart documents this chief cyclical and structural problem in America: a chronic and progressive weakness in investment.

THE ROLE OF CAPITAL FORMATION

Capital formation is of strategic importance not only for long-term growth, but also as a demand component for the short-term business cycle. America's extremely low savings and investment ratios are

well-publicized facts . . . President Clinton cited them. Less well-known is the fact that the downtrend in investment is a lot worse than it appears as measured by gross fixed investment. The reason this is so is because current capital consumption — depreciation in other words — is rising faster than current gross investment. While gross investment may be rising to wide acclaim, if it's doing so slower than depreciation then net investment will shrink. That's exactly what's occurring in the United States presently. Beware of the statistics that show rising gross investment. It's net investment that's really the important factor. On top of all this, we must also take into account the large disinvestments that are taking place as the corporate sector continues its wave of "downsizing." All in all, America is probably experiencing a shrinking capital stock currently.

Net private domestic investment is down to a level of barely 2% of U.S. GDP. That compares shabbily with levels of 5% in 1980 and 6% in 1985. Such an abysmal ratio as we are seeing now has only occurred once before in history — in 1929-39. What makes this condition even worse today is that it coincides with a large current-account deficit. That makes it difficult for the U.S. to borrow foreign savings for domestic investment, let alone for consumption. In light of these facts, the forecasts for productivity-led growth must truly be seen to be bizarre. How can that happen with such low investment ratios? It's simply not possible. Forget about the notion of a productivity-led recovery.

OTHER INVESTMENT SPENDING ILLUSIONS

The disastrous trend in net capital formation arises from two main causes: firstly, a retardation in the growth rate of gross investment as weak new investment lags rising depreciation charges; and secondly, a drastic shift from long-lived capital investments toward short-lived investments. What's happening is that companies are opting for investments with quick paybacks given continuing high real interest rates. Rather than adding to capacity, they elect to shrink down to a more productive core. Putting it more simply and plausibly, there's a shift from a building boom to a computer boom.

The above phenomenon also explains why the cash flow of the U.S. corporate sector is reported to be so high — the highest on record. While on the surface this trend may seem highly constructive, it's important to realize that cash flow has risen to such highs because depreciation has risen sharply. Depreciation charges, added to profits and other items, makes up cash flow.

Given the economy's protracted weakness, it appears that business investment has held up remarkably well. But, it is very narrowly based. It is concentrated on one single item: information processing equipment — most of it office equipment. Meanwhile, spending on structures and industrial equipment has been cut. Both trends are absolute proof of what is driving business investment: efficiency and cost cutting, not capacity or output needs.

There is much applause for the computer boom. While the benefits should be praised, one shouldn't overlook the drawbacks. First of all, computers are no substitute for aging goods-producing machinery. Secondly, computer production involves very little labour while their utilization heavily displaces jobs. Surely, computers are not particularly suited to solve unemployment problems. In fact, as the currently cut-throat price competition suggests in the computer industry, it is plagued by overcapacity itself.

PRODUCTIVITY WITHOUT PROFIT

There are enormous differences between the characteristics of the present recovery and past recoveries

which were driven by building booms. The latter were labour-, capital-, and credit-intensive, and of all things, tended to produce a real boom. Conversely, prolonged economic slumps have always been associated with prolonged slumps in building. As well, the former type of recoveries were more associated with price inflation pressures. That's a point to bear in mind for those who are trying to predict inflation rises. Still, we wonder about this strange jobless recovery and its economic implications. From a purely financial perspective, the corporate sector has gained tremendously. The booming stock and bond markets have made new debt and equity cheaper than at any time in almost two decades. In addition, businesses have enjoyed the benefits of four different profit stimulants: lower raw material costs; extremely moderate wage rises; cyclical productivity gains, plus a flood of money from the soaring budget deficit.

All these substantial betterments should give rise to a veritable profit boom. So far, it's not there. True, profits have recovered from their 1990-91 lows, but looking at operating profits as reflected in the official GNP data, they only show a paltry improvement compared to the rises of past cyclical upturns.

Seen from a long-term perspective, the profit trend is worsening in terms of share of GNP and profit margins. Profits are still well below their levels of 1988-89, a fact supported by a graph we've shown a number of times in past issues. The cardinal fact, often overlooked, is that low wages by themselves don't make for higher profits if they fail to induce capital investment. This is the principal flaw in the conception of a "productivity-led" expansion. Ominously, plant shutdowns and corporate downsizing continue in full force even during the expansion.

THE LINKAGE TO FINANCIAL MARKETS

How to break out of this vicious circle is the daunting task confronting U.S. policymakers. Is Clinton's policy package suited to achieve this? Sadly, no.

First off, we can only repeat what we said earlier about the current conception of a "productivity-led" expansion: It can't last and amounts to not much more than wishful thinking. The key question really is what businesses chose to do with their rising profits and cash flows which, presently, are higher relative to investment spending than at any time in the postwar period.

The ominous point is that businesses are clearly not pumping their cash surpluses back into the economy through higher investment or hiring. Instead, much of it is being warehoused or used to pay down debt. The money-making game is in the financial markets, not in the real economy. In the final analysis, businesses are exerting a big drag on economic growth. What has driven the economy so far is the soaring budget deficit and the profligate, spendthrift consumer. On this base, we don't think the recovery can continue for very long.

The bottom line of all this is that the U.S. economy is vulnerable to a marked slowdown, if not worse. It is definitely not experiencing a normal, self-feeding recovery. In the absence of substantial job and income growth, a sustained expansion is impossible. On the favourable side, however, this implies two things: firstly, low inflation; and secondly, persistently low short-term interest rates. We must hasten to add, though, that U.S. short-term interest rates are artificially low for reasons we discuss next.

UNDERPINNINGS OF A FINANCIAL MANIA

What has enabled interest rates to fall so sharply? What has driven the stock and bond market into such

a frenzy? To start with, it has essentially been orchestrated by the Fed. During the last two years, the Fed bought $45 billion in government bonds. Doing so out of thin air, it immersed the commercial banks in an unending supply of excess liquidity. The banks, in turn, responded by stampeding into government bonds purchasing a multiple of that amount — roughly $200 billion. The third extraordinary and large buyer of U.S. government bonds were the brokers. Financing themselves mostly by repos in the money market, they increased their bond holdings by a staggering $150 billion. Last but not least, foreigners — above all central banks — purchased $120 billion. Together, these four buyers absorbed more than 50% of the total credit expansion during this period. That's why interest rates were able to fall.

The heavy hand of the Fed creating ultra cheap money and the bond market euphoria, in turn, have buoyed the stock market by chasing tens of thousands of people into the securities markets via mutual funds and away from low-yielding CD's and deposits. In this way an unmanageable financial mania has been born.

Most obviously, the falling U.S. interest rates are not the natural result of rising savings or falling inflation. In reality, they are the unnatural result of a massive monetization engineered by the Fed. Where will it all lead? We can only counsel that one should be aware of this precarious development. Long-term dollar bonds must be recognized as being highly speculative. How long can it go on? It's possible — although unpredictable — that the current financial mania in the stock and bond market can last longer.

THE DECEITFULNESS OF INFLATION

A second force contributing to the financial mania is the encouragement of legions of cheerleading economists who counsel that stock and bond prices can only rise now that inflation is permanently licked. First of all, it's always foolhardy to declare that inflation has been licked. Inflation is something that has to be constantly guarded against and always has to be fought anew. Every downturn in the business cycle has been associated with a decline in the rate of inflation; every upturn has been followed by rising inflation. What perpetuated the low inflation rate during the last years has mainly been the protracted economic weakness of the U.S. economy. More precisely, what has occurred is a condition of "suppressed inflation." The true test will only come with a truly strong economic recovery.

Economists of the Anglo-Saxon school have always been prone to blindly equating a low inflation rate with a healthy economy. It was exactly that belief that proved to be the decisive error in the 1920s and 1930s. Stable consumer prices between 1922 and 1929 gave rise to the comforting perception that the economy was in tip-top shape. The fact that inflation roared in real estate and stock prices was regarded as having no relevance to "basic" economic conditions.

THE MALIGN AND IGNORED EFFECTS OF INFLATION

The essence of inflation is not rises in general price levels, but an overexpansion of credit relative to available savings. Depending on how excess money is spent, a credit inflation can have different effects on the economy and its financial system. Its most malign and ignored effect always is the disruption of the existing demand and output structures. The most dangerous legacy of the 1980s credit inflation was a treacherous asset price inflation occurring at a time that price inflation (consumer price inflation) appeared to be declining. It resulted in huge malinvestments — particularly in real estate — and fuelled soaring consumption ratios.

We often get letters from North American readers asking us about the prospects for inflation. Although the inflation rate of goods and services is declining under the pressure of protracted economic weakness currently, comparing current credit growth with the meagre flow of savings, it's apparent that America still has rampant inflation. The inflation is expressed in the trade deficit and in the financial markets. In the absence of demand for money to finance real economic activity, excess money floods into alternative channels and is directed towards the securities markets. Stock and bond prices rise.

Inflation hasn't been licked at all. Economic weakness and the trade deficit are suppressing its expression in consumer prices. Meanwhile, the U.S. economy's long-run inflation bias is worsening. The seeds of this growing inflation bias — one that applies to all the Anglo-Saxon countries — lies in the drastic shift of resources away from productive investment towards consumption. The pressure of large budget deficits and low savings imposes a bias on monetary policy towards artificially low interest rates. But instead of driving the real economy, low interest rates fan up reckless financial speculation thus creating a new set of problems. It's perhaps the greatest irony that in this way, paraphrasing Keynes, the financial system aggrandizes itself by stealing money from the industrial circulation.

You can make a case that at a certain point, when interest rates have fallen enough, money will finally be lured into the real economy as always. In the opinion of some economists, when that happens, inflation will jump from the financial markets into the real economy.

We don't buy this argument because money will simply be unable to get out of stocks and bonds at the existing market prices. Money will be able to move out of deposits, yes, but certainly not out of the overinflated pile of securities assets. The main chink in the scenario is the extreme exposure of banks and brokers to any monetary tightening. As soon as they see risk of any kind, they will rush to unload.

After having orchestrated this new speculative financial mania, given the overheated and overleveraged financial system, we wonder whether the Fed still has the option of applying the monetary brakes should inflation ever return. What, then, could finally stop the speculation and collapse the bubble?

LOOKING FOR THE PIN THAT WILL PRICK THE BUBBLE

The one most obvious risk is an accelerating, robust U.S. economic upturn that forces the Fed to tighten. Fearing a significant rise in interest rates, banks and brokers would start to unload some of their bond holdings. Given the giant size of these portfolios, such a step would play havoc with the bond market, sparking a rapid, sharp rise in long-term interest rates. In turn, that would thrust the securities markets and the economy into a new liquidity crisis thus certainly aborting any recovery. It could well be the beginning of a real deflation. But since we see no sustained recovery, let alone a self-reinforcing one, we don't anticipate a monetary tightening that could prick the bond market bubble.

However, we see other risks. The vast, unprecedented accumulation of bonds being in the hands of banks and brokers who are highly sensitive to changes in monetary policy compels the Fed to avoid pushing up short-term interest rates at almost any cost. Therefore, the longer this mania lasts, the surer the Fed will lose control over its policies. In fact, we think the Fed has already lost control.

Somewhat paradoxically, an alternative risk for the stock and the bond market would be for the economy to turn out much weaker than expected. That's the risk that we have had in mind all the time and which we expect will result later this year. This outcome is least expected. A recent poll of professional

investors conducted by Barron's cited the economy and the dollar as the least worrying factors for market prospects in 1993. A renewed weakening of the U.S. economy will be the biggest surprise and shock for the consensus view. If resulting dollar weakness then deteriorates into a dollar crisis, short-term rates will rise, thus sinking both the U.S. stock and bond markets in a fashion similar to the first scenario.

THE DOLLAR IN THE CONTEXT OF THE INTERNATIONAL ENVIRONMENT

For the time being, the view of economists on the world economic outlook is unanimous: The U.S. economy is experiencing a robust recovery, while Europe is in recession. Clearly, the business cycles on the two continents are intersecting. But in the perception of many people, this reciprocal cyclical movement is blown up to an event of monumental economic importance. The U.S. economy is viewed as being super-healthy and dynamic given that inflation is seen to be permanently vanquished while the European economy is diagnosed as being sick to the bone.

If one confines the analysis to one or two years in isolation, that assessment seems plausible. But a longer-term perspective is required to draw more reasonable and balanced comparisons. For example, the fact that the German economy, the lead locomotive for Europe, has grown 10% since 1989 while U.S. real GDP grew by only 2.5% immediately puts a different slant on the analysis.

Still, we are not at all optimistic about the near-term outlook for the overall European economy. Its major economies are facing outright recession this year. But given the essentially temporary German unification boom, a sharp slowdown appeared inevitable. The key issue, in our view, is the nature of the causes of these recessions. Are they rooted in deeper-seated, long-term debt and structural problems or in cyclical monetary tightening? The element that makes us worry most about the German economy is not so much its internal condition, but the deteriorating international environment, particularly the renewed weakness of the U.S. economy.

Our unchanged bearishness on the U.S. dollar is founded on reasons internal to the U.S. economy — both short-term and long-term. The short-term problem for the dollar concerns the grossly overinflated recovery expectations; the long-term problem is rooted in the economy's structural ills which have yet to see any improvement. If President Clinton is serious and successfully cuts the budget deficit, it will mean pain and still lower economic growth in the short run. If he fails, it will mean certain disaster in the long run. Wall Street's euphoria makes us wonder about America's resolve for austerity.

NO END TO EUROPE'S CURRENCY TROUBLES

Europe's monetary system is in shambles. We aren't surprised. For years we have been warning that its much-praised stability was a mirage caused by perverse capital flows. Money flowed into the high-yielding, inflationary currencies on the expectation that exchange rates would remain fixed. We predicted that these currencies would collapse as soon as recession forced their central banks to lower interest rates.

Tensions have waxed and waned within the ERM (European Rate Mechanism). Now, the unpleasant surprise is that decoupling from the D-mark — devaluing in other words — isn't such a sure-fire way of achieving lower interest rates. Spain has 20% unemployment and despite devaluing is still burdened with short-term interest rates as high as 20%. Yet, the Spanish Peseta remains under strong pressure. Short-term interest rates still hover around 12% in Italy; in Denmark between 15-20%; in France around 11%.

Again and again, there are media reports suggesting that Germany and France intend to cement their currencies at a fully fixed parity. That would do away with fluctuations and any chance for devaluation. We think there's no chance for such an arrangement because it would oblige the Bundesbank to intervene on behalf of the French franc without limitation. Though the Bonn government may have the legal authority to engage in such an exchange agreement, the deal would practically be null and void. Why? The government has no power to compel the Bundesbank to discharge the agreement. There is a written agreement between the Bundesbank and the government, dating from 1978, that stipulates that the central bank cannot be obliged to make interventions that impair its autonomy and its ability to defend price stability. This was a clause that was insisted upon when the EMS (European Monetary System) was created. As such, Europe's currency troubles may not be over yet.

CONCLUSIONS

Worldwide, economic weakness is spreading. For a time, Japan and Europe have been the unpleasant surprises. The United States will be next. Massive monetary and fiscal stimulus have failed to generate a self-perpetuating expansion.

As the U.S. recovery peters out, the Fed will keep short-term interest rates low. European recession, though, points to further cuts in interest rates thus promising continuing strong bond markets in the hard currency countries.

In the U.S., what we see is this: a huge volatile, combustible pyre of overinflated stock and bond prices piled ever higher by a central bank that can only tighten at the peril of the financial system and the economy.

Currency market considerations remain the most important. Though the dollar has lost momentum, it is still underpinned by euphoric U.S. recovery forecasts. Renewed economic weakness, we think, will signal the next sell-off.

Our investment recommendation remains the same. For safety, good yields and capital appreciation, hard currency bonds — the top-quality government bonds of Germany and Switzerland as well as Austria, Belgium and the Netherlands — remain the safest investment preserve for prudent long-term investors.

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